

Forum Series on the Role of Institutions in Promoting Economic Growth

Preparatory Fieldwork Proposals for Designing Institutions for SME-Friendly Trade Liberalization

An application of the HPI framework

CLIFFORD ZINNES AND OMAR AZFAR

Preliminary version

**Forum 3
An Application of the HPI Approach to a USAID Programmatic Area**

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About the Series

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Preparatory Fieldwork Proposals for Designing Institutions for SME-Friendly Trade Liberalization

An application of the HPI framework

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May 31, 2002

Abstract

In a companion paper we analyze through the lens of the New Institutional Economics (NIE) the institutional obstacles identified by Nugent (2002) for trade liberalization to generate benefits for small- and medium-sized firms (SMEs). Based on our analysis, that paper proposes a series of institutional options to overcome each of the six obstacles identified. It then describes the likely nature of the donor assistance to support the options.

The present paper has two purposes. First, we propose a series of field-based studies to determine which of the institutional options (developed in the previous paper) might be preferable, given a particular country's initial conditions. Second, we select the studies whose empirical techniques illustrate how to implement a HPI framework (Zinnes and Bolaky 2002) application.

We envision USAID/WDC and field mission participation in three ways, as the subject of inquiry (are there internal, organizational incentives that influence outcomes?), as clients describing the situations in which they need empirical tools, and as a collaborator (sharing their insights with the Forums team).

We expect the financial and human resources required to implement the proposals suggested herein exceed those available under the Forums Project. This has been done intentionally for several reasons. First, it provides the HPI end-user with a richer set of examples with which to understand the approach. Second, it allows USAID (and the Forum-3 discussants) to select a subset of activities based on need and merit, rather than being offered a fixed list. Finally, the broader choice of fieldwork alternatives means that if at the early stages of work one becomes infeasible, we still have fall-back options readily available.



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An application of the HPI framework

CLIFFORD ZINNES AND OMAR AZFAR^{*}

Version: May 31, 2002

In a companion paper we analyze through the lens of the New Institutional Economics (NIE)¹ the institutional obstacles identified by Nugent (2002) for trade liberalization to generate benefits for small- and medium-sized firms (SMEs). Based on our analysis, that paper proposes a series of institutional options to overcome each of the six obstacles identified. It then describes the likely nature of the donor assistance to support the options.

The present paper has two purposes. First, we propose a series of field-based studies to determine which of the institutional options (developed in the previous paper) might be preferable, given a particular country's initial conditions. Second, we select the study methods to illustrate how to apply the empirical techniques required to implement a HPI framework (Zinnes and Bolaky 2002) application, a methodology to identify and design NIE-based reforms. Prior to commencing and because it forms the methodological basis for our work, in section 1 we briefly recap the salient motivations and features of the HPI approach (pronounced "hippy" and abbreviating "Harnessing the Power of Incentives").

We envision USAID/WDC and field mission participation in three ways, as the subject of inquiry (are there internal, organizational incentives that influence outcomes?), as clients describing the situations in which they need empirical tools, and as a collaborator (sharing their insights with the Forums team).

After the review of the HPI approach, sections 2-7 describe a series of empirical proposals to select among the options for each of the obstacles identified in the earlier papers. The proposals also include, as appropriate, how the various options would be calibrated. We then briefly

^{*} The authors express their thanks to the USAID Forums Steering Committee and to Albert Berry, Chas Cadwell, Avner Greif, Jeffrey Nugent, and Pablo Spiller. All errors remain with the authors.

¹ See Azfar (2002) for a detailed description of NIE.

present arguments in support of a short-list of countries, which we believe are particularly suitable as a group for the HPI application. We end with a summary of these proposals to facilitate the comparison among them, their time and human resource constraints, and the different internal objectives and requirements of USAID administrative processes.

1. A review of the HPI approach

Before it reaches the targeted beneficiary, a successful development assistance activity has to pass through the hands of many actors, including a slew of administrative and specialist individuals and committees within USAID, the implementing agent (which could be a government, private sector or non-profit agency), the recipient government political and administrative levels, and potential recipient country facilitators, to name but a few. Each of these actors has her own objectives and therefore idiosyncratic incentives, perhaps only incidental to those of USAID. On the other hand, many of these agents possess skills and information that could contribute to the success of the activity. How does one encourage these actors to enthusiastically provide their contributions without at the same time allow them to engage in potentially opportunistic behavior, which might derail the overall activity? Likewise, how can strategy, program, and activity designers at USAID not just avoid the pitfalls of these incentive conflicts and information asymmetries but explicitly harness them for the good of the intervention?

Based on the new institutional and transaction cost economics, the HPI framework includes techniques that USAID may use both to reduce the risk of having their interventions “hijacked” or blunted by uncooperative collaborators as well as to turn these embedded incentives to their own advantage. The framework comprises several levels of analysis, each addressing different aspects of the aid program cycle.

What is the big picture and what are the aggregate lessons learned? The **Macro Level** begins by “mapping” out the organizational relationships of a sector and identifies the salient transactional interfaces linking them. It then looks across activities and countries – typically using panel econometric analysis – and identifies donor, recipient country, implementer, and activity characteristics that enhance the probability of a successful intervention or increase the likelihood of failure.

What are the rules of the game and the pay-offs? The **Meso Level**, corresponding to the political economy dimension, identifies the interests of actor organizations and the games they

play. With it, USAID can better understand how the key stakeholders interact and, equally importantly, manage its interactions with other organizations, including recipients as well as its own implementers. While some survey-based, econometric analysis is also feasible at this level, the most useful tool here is the **analytic narrative**, a game-theoretic case study (Bates *et al.* 1998). We also believe that **controlled experiments** may be run to explore how organizations might react when within a game made up of a pre-determined – though as yet non-existent – institutional arrangement or (incomplete) contract..

What do the players know, expect, and plan to do? The **Micro Level** elucidates the games and incentives facing the individual decision-makers *within* each organization and how these internal incentive structures may ultimately lead to stable but inefficient – and even perverse – aid outcomes. (We must include here the possibility to improve incentives and collective action within and between USAID and its field missions and on the design of governance structures to improve implementer and USAID staff performance.)

The key tool at the Micro Level is the **micro-survey**, which seeks several things. First, it seeks to identify decision-maker (stated) preferences, expectations, habits, and beliefs. Second, it seeks to extract asymmetric information for which the decision maker, being closest to the institutions under inquiry, is uniquely expert. Finally, it seeks to reveal the **willingness to pay** for or willingness to accept alternative institutional mechanisms or socio-economic outcomes. We also believe that **controlled experiments** may be run to examine how individuals *within* organizations might behavior when faced with the set of incentives implicit within the governance structure of a pre-determined – though as yet non-existent – hierarchy, principal-agent relationship, or selection opportunity.

At the same time as clarifying reform options, these three levels of analysis also provide guidance on the evaluation process. The indicators constructed at the Macro Level provide a benchmark for the aggregate effect of USAID interventions (“treatments”). Based on the micro-surveys and controlled experiments of the Meso and the Micro Levels, the HPI approach proposes the use of **randomized, prospective pilots** to test alternative institutional solutions.

Based on the concepts of NIE, HPI provides the series of tools described above to aid in the identification of opportunism, transaction costs, and reasons for contract failure (implicit or formal). It stresses that the reduction of uncertainty about actions and the alignment of incentives

improve outcomes. The proposed tools address these factors in several ways as listed below and, as such, appear in several guises in the research proposals that follow.

Reducing uncertainty and transaction costs

- By clear documentation and publication of actions. For example the Ugandan government publicized how much it was giving to each school and clinic which apparently significantly reduced leakages.
- By rigorous studies on what different actors are doing and the effectiveness of their efforts.
- By using markets to produce information on beliefs. “Betting markets” can be most effective at this
- By undertaking costly actions to signal intent (credible commitment).

Alignment of incentives

- By taking care to accurately measure the variables the principal cares most about. Failure to do this, and basing incentives on poor proxies for success, can be distracting rather than motivating (Azfar 2002).
- Lengthening the agents’ time horizons. Another insight of NIE is that repetition engenders cooperation and happy outcomes. Lengthening the time horizons of agents therefore can improve outcomes. This applies to deferring large parts of payments to government servants and indeed even accountants and private service providers.
- Targeting individuals. Incentives should where possible be targeted at particular individuals in organizations rather than loosely at organizations themselves.

2. SME obstacles to domestic and international market access gains

As outlined in Zinnes and Azfar (2002), SMEs have poor access to the gains from trade either because in some countries and sectors they have poor access to trade itself, or because trade with foreigners is dominated by large monopolistic firms who capture most of the gains from trade. The question being addressed in this set of research proposals are how to improve access to the gains (economic “rents”) from trade by changing the distribution of rents in a way that *increases* efficiency. This may require the creation of new institutions (like NGOs or cooperatives) to intermediate between SMEs and foreign markets. In that case, we ask how one

should structure incentives for these institutions and how to measure success. These are related because the clearer the measure of success, the higher is the power of the incentive.

2.1 Macro-Level analysis

Institutional mapping. Different countries would have different institutional environments and different goals for USAID. The first stage of the HPI approach, then, is to identify the organizational actors and their transactional interfaces. To do thus we must describe and map out the institutional environment, commercial laws, law enforcement, legalized monopolies for marketing boards, other institutional players, and stakeholders. This sets the stage for the following HPI steps, namely the Meso-Level (analytic narratives and statistical analyses)

Resource requirements: LOE: 15 days Research assistance: 1 months Travel: 0

The effect of barriers to marketing. We would also try macro level comparisons across countries and across sectors within countries. One variable which will be informative about the distribution of rents is the ratio of the international price and the farm-gate price for goods. In countries with competitive marketing structures these two prices are likely to be closer than in countries with monopolistic marketing structures. This ratio would also vary because of differences in the value/volume ratio, and the perishability of the good as well as institutional characteristics like the need to pay tariffs at informal and legal roadblocks. Perishability is likely to confound this problem by increasing the bargaining power of the people setting up the roadblocks.

We might eventually estimate a regression like

$$(\text{Farmgate price/International price}) = f(\text{Market structure, perishability, volume/weight, corruption.....})$$

Resource requirements: LOE: 30 days Research assistance: 1 months Travel: 1

2.2 Meso-Level analysis

Analytic narrative on producer cooperatives. There are examples of producers forming cooperatives to market coffee etc. The impacts of these developments could be studied. There are some relatively clear game-theoretic predictions that could be generated, like a producer cooperative

improves bargaining power vis-à-vis middlemen and therefore the distribution of the gains from trade shifts towards producers. Also the effectiveness of a particular cooperative may depend on the clarity and sensibility of the rules which govern it.

Resource requirements: LOE: 40 days Research assistance: 1 months Travel: 0

Analytic narrative on the motivational incentives for NGOs. The game-theoretic literature on NGOs focuses on the no-distribution constraint and the impact this has on the incentives of both owners and workers of these organizations². An analytic narrative could be used to explore whether the no-distribution constraint actually binds in particular instances, whether de facto it is more of a “slow” distribution constraint, because profits can eventually be distributed as wages.

In fact, a “slow” distribution constraint may have several useful properties and a “not-for-short-term-profit” institution may be better than the two “pure forms”, for-profits, and not-for-profits. It keeps many of the cost-reducing and efficiency-enhancing incentives of for-profits but discourages the short-term opportunism which can lead to lowering product quality or adherence to environmental or labor standards. Indeed a “not-for-short-term-profit” institution may have clearer incentives to maintain a good reputation than either for-profits or not-for-profits because unlike for-profits, managers will not immediately have control of profits, but unlike not-for-profits, they will eventually gain and therefore might care more about the value of reputation. Since institutional innovation allowing for this new institutional form does to an extent regularize existing practices, it is more likely to take hold than a alien institution.

After examining the de facto effectiveness of the “no distribution” constraint we would try to understand what actually motivates NGOs and whether (long-term) profit motives might improve outcomes. If so we would work out the optimal institutional structure of “not-for-short-term-profit” institutions.

Resource requirements: LOE: 50 days Research assistance: 1 months Travel: 0

² Many students of the “not-for-profit” sector argue that its existence is due to the fact that those who control these organizations do not have the authority to take residual revenues home as profits. This encourages donors both private and governmental to trust them with donations to a greater extent than they would trust for profit firms. This implies that “not-for-profits” may be appropriate institutional form when the receivers of services are not the same as those who pay for them.

Analysis of US-based fair-trade organizations. The Fairtrade foundation, which is located in Downtown Washington, appears to have balance sheet data on 80 fair-trade organizations 60% of which are for profit, the rest being cooperatives or NGOs. Some statistical analysis of cost-effectiveness should therefore be possible. We may also be able to arrange some telephone and face to face interviews with the managers of these organizations. Among the questions we could study is the relative cost-effectiveness of for-profits, not-for-profits, and cooperatives.

Another question is whether we would expect more for-profits to enter the fair-trade market as the meaning of fair-trade is clarified. In the presence of concrete labor and environmental practices that fair trade organizations must follow and demand from their subcontractors a profit motive is likely to be motivating and lead to greater efficiency. However in the absence of such clarity its likely to lead to cutting corners on environmental and labor standards. We would try to clarify what are the theoretical predictions on the impact of for-profit and not-for-profit fair trade organizations on growth and distribution, and examine whether these predictions hold in practice. We would also examine whether the number of for-profits has increased as the meaning of fair trade has been clarified and the observability of adherence improved.

Resource requirements: LOE: 30 days Research assistance: 1 months Travel: 0

Survey-based evaluation of a past SME-friendly liberalization³. One of the many reasons that the gains from liberalization do not trickle down to the poor is that the poor do not have access to complementary factors, often because of poor institutions. The poor may for instance lack access to credit because commercial laws and law enforcement is poor and lenders do not believe that they would get their money back. Or the poor may not be able to take part in market activity because buyers do not trust them to provide good quality products and do not trust the effectiveness of legal remedies when they do not provide good quality products.

Survey-based data can be used to measure effectiveness in terms of *user satisfaction* with assistance, the *economic impacts* of the assistance – e.g., whether users actually managed to access new markets – and *political impacts* – e.g., whether users have changed their views on the benefits of liberalization.

³ Similar analyses may also be proposed for other obstacles based on the example here. It is worth reading this section carefully even if the obstacle we apply it to is not selected.

Trade facilitation projects are often conducted at the local – municipality or even village-level, which will allow us to conduct an impact analysis within a country. We are helped here by the reality that USAID cannot finance a trade association in every municipality or village and a comparison is therefore possible between areas which received technical assistance for a trade association, and areas which did not receive technical assistance.

Surveys and other forms of hands-on data collection can be used to collect data of several kinds, which can be useful for an impact analysis. The managers of SMEs can be asked “test-of-knowledge” questions about WTO regulations, they can be asked if their import volumes had grown, the reliability of other firms in the trade association, and whether they have raised wages and employment. The workers at SMEs should also be surveyed and asked about changes in wages and employment and perhaps other factors. In general, more than one person at each SME should be surveyed so that reliability tests can be conducted on the data. The surveys of managers and workers could also include questions about political support for globalization, to examine whether and to what extent trade facilitation helps build a constituency for reform, and how active this constituency is in supporting reform. It may also be useful to survey a randomized sample of households from the village to try to assess any spillover effects from the trade facilitation program. We would also collect data from the workers and managers of the firms and NGOs which contract with USAID for the provision of technical assistance, and from the workers and managers of the trade association. This would help us assess the levels of meritocracy and accountability in these organizations and examine whether these management practices affect the quality of services. In this study since the programs are funded by USAID we may have the leverage to examine the actual accounts and provide an assessment of financial accountability based on this examination as well as the usual survey questions.

The quality of management at the field offices of the contracting organizations and the trade associations might have an important impact on the quality of services provided. The data we collect could be used to examine this hypothesis with the estimation of the following equation at the cross-jurisdictional level:

$$\text{Project success} = \text{Meritocracy in hiring and promotion} + \text{accountability in finance} + \dots$$

We will construct the right and left hand side variables of this regression from the responses of different respondents to minimize the possibility of our results being driven by respondent bias.

The ideal place to study the impact of a trade facilitation program would be a country where – perhaps for reasons of fairness – the trade facilitation program was conducted in randomly selected areas. This would allow a randomized evaluation, which is scientifically the most hardnosed and easily defensible evidence available, and the easiest to communicate to non-technical audiences (Kremer 2002).

Failing the availability of a program which was implemented with deliberate randomness, a persuasive impact analysis could also be conducted as long as the criteria for selection of a village or municipality for technical assistance were clearly stated. New estimation techniques like “regression discontinuity analysis” can be used to assess the impact of projects quite persuasively, if the criteria for selection into the “treatment” sample rather than the “placebo” sample are clear.

The information collected by the surveys can also be used to provide contingent payment incentives to the firms and NGOs providing technical assistance to the SMEs. This information could also be used to provide incentives for USAID staff. One of the main insights of NIE, and the more recent work on the principal agent problem (Azfar 2002, Holmstrom and Milgrom 1991) is that incentives based on factors imperfectly related to good outcomes – like incentives based on inputs – can be distracting rather than useful. The survey based information we collect will allow incentives to be based on outcomes as well as inputs, allowing a better alignment of incentives between principals (USAID) and agents (contractors). It may also make sense to delay incentive payments and make them contingent on long-term performance so that USAID staff and contractors don’t try to maximize the short-term returns from the activity at the expense of long-term performance (as they might for instance by failing to adhere to stringent quality standards which might improve short-term payoffs at the expense of long-term gains).

In other words, one of the important pathologies of aid is the broken feedback loop between recipients and those funding and directing the activity (Martens, Mummert, Murrell and Seabright 2001). The survey based information we collect will close this broken feedback loop and improve the delivery of aid.

Resource requirements: LOE: 120 days RA: 2 months Local team Travel: 2 trips

A (future) randomized study⁴. The third part of this component of the Forums project is the design of a technical assistance project in such a way that a randomized assessment is possible in the future. While at first it may not appear politically expedient to randomly choose the target municipalities for a reform program, in fact such random selection may make sense for several reasons. First random selection is almost by definition fair. Second random selection allows the production of hard knowledge on the effectiveness of programs, such knowledge is a public good and eventually even those municipalities which were not selected in the first round of the program would benefit from the increased resources allocated to it if the program is in fact effective. In other words aid can in this way be leveraged usefully by providing demonstration projects, and improving the allocation of the much larger sums available in domestic programs (Collier 2002). Third, if there are municipalities that are obviously either high priorities or inappropriate for intervention, these could be selected – or deselected – in advance. If there was randomization among the others this would be enough to allow a random evaluation. It should be noted that it is unrealistic to do both the design and the evaluation of a single project within the lifetime of the Forums project.

This design which will permit eventual randomized evaluation, could include random selection of villages into categories where technical assistance is delivered by the following mechanisms:

- Private firms without outcome based incentives
- Private firms with outcome based incentives
- NGOs without outcome based incentives
- NGOs with outcome based incentives

This would allow an examination of what contracting mechanisms are most effective at helping SMEs take advantage of trade liberalization.

Alternatively we could randomize on the structure of the trade association, to examine which is the best organizational form. For instance NIE suggests the performance of joint liability works best when the members of a club –trade association- can decide who to let in and thus

⁴ Similar analyses may also be proposed for other obstacles based on the example here. It is worth reading this section carefully even if the obstacle we apply it to is not selected.

keep out those who might renege. However self selection might also keep out the poorest and prevent the equitable spreading of the gains from trade. We might therefore deliberately randomize the institutional design of the trade association, making it easier for existing members to block new entrants in some areas and examine the impact of these institutional difference on outcomes.

We could also widely publicize the evaluations of the reliability of the members of various trade associations, and the trade friendliness of the local governments in various regions and examine whether inducing competition among them leads to better outcomes.

We will collect data before the technical assistance project is conducted, so that the *ex post* evaluation, when it is conducted will have a benchmark and be able to conduct an impact analysis.

Resource requirements: LOE: 50 days Research assistance: 2 months Travel: 0

3. Government's inability to commit to future implementation

A principal source of institution failure stems from a government's inability to credibly commit to a future action. This is *not* a problem of finding sufficient funding. Since the theoretical net gains from trade are generally considered large and positive (especially if the negative externalities can be ameliorated), those who gain should be more than able to compensate the losers. If all losers would be compensated, who would oppose trade liberalization or the success of its implementation? Unfortunately, even if the government genuinely intended to make good on such commitments, it does not generally have the institutional mechanisms available to do so. This might either be because the government lacks the technical capacity or because it cannot *credibly commit* to do so. The resulting outcome is inefficient.

The need for credible commitment impedes many potential solutions to the obstacles analyzed in Zinnes and Azfar (2002). In that paper we propose several alternative, concrete, institutional commitment mechanisms that would improve the likelihood that government promises would be viewed as credible (time-consistent). These include:

- “Talk the talk; walk the walk”: Signal commitment through actions such as stakeholder participation, and others which would be unprofitable for the non-committed.
- “Just do it!”: Rather than commit to a future action, do it in advance.

- Create a sustainable delivery mechanism: Create an organization up front with autonomy, independence, and financial sustainability to deliver the future benefits
- Buy it up front: Even if it is infeasible to “Just do it!”, the “it” can still be paid for in advance, an extreme case being an assurance bond.
- Targeted but indirect compensation: Legislated commitments to increase such benefits as education or health may be included in the trade liberalization legislation.

In this section we propose a number of HPI-based studies (Zinnes and Bolaky 2002) that illustrate how to determine which of these options might be most appropriate for a given set of conditions. These studies focus on providing light on several design issues. First, across all countries in which USAID has supported trade liberalization, how important has a country’s track record of commitment been in a government’s success to co-opt parties likely to be affected by trade liberalization? Second, what policy instruments and complementary reforms are most effective in strengthening the credibility of the government’s commitments? How much more effective are “up-front” commitments over promises of simultaneous implementation (with trade liberalization)? Does the use of public participation increase the government’s ability to co-opt potentially adversely affected stakeholders or is it better for the government to sneak the reform past everyone, introducing it as a surprise and *fait accompli*? Third, does the participation of USAID (and in what way?) have an effect on the answers to these questions?

3.1 Macro-level analysis

Here we begin by illustrating how to identify the main players in the credible commitment game and how to construct an institutional map of the transactional interfaces. We then develop measures of relevant outcomes as well as of factors influencing them – including USAID activities.

Based on these measures, we propose to conduct a retrospective statistical analysis to determine the main lessons learned regarding the role of credible commitment in past reform experience. To do this we intend to build a data set of qualitative variables and relevant initial conditions within a country to measure the *ex ante* credibility of a country to make good on its promises regarding the implementation both of trade liberalization as well as of the complementary reforms to address trade externalities or adjustment. We could also examine the effectiveness of certain actions by the government in producing the credibility of its commitments. The use of betting markets to generate information on this is discussed in section 2.3 below. We will

also examine whether the presence of donors or public participation made a difference in this credibility. Of particular interest viz. public participation is the associated question of whether the reform was more likely to be successful when it was sprung on the stakeholders as a *fait accompli* or when sufficient time was taken to build consensus for it.

Resource requirements: LOE: 35 days Research assistance: 2 months Travel: 0

3.2 Meso-level analysis

The Macro-level analysis above examines the role of credible commitment in one reform area (trade liberalization) but across multiple USAID recipient countries. For the Meso-level we propose a similar analysis that looks across multiple reform areas but within one country. In this way we can determine what the government's track record (reputation) on credible commitment has been historically. We can then compare the record to a survey of public opinion on the same. As before, we would examine the role of USAID and the government's use of public participation (and the impact of the speed of the reform process) in increasing the government's credibility.

Resource requirements: LOE: 35 days Research assistance: 2 months Travel: 0

Signaling mechanisms for a market betting on the seriousness of reform. One way for a government to show that it is serious about reform without having to do it all at once is to post an "assurance bond". The government can post a bond in an international bank or other institution that it will forfeit if it reneges on the promise to liberalize. There are two problems with this. First developing country governments are often cash strapped and the need to post this bond may have real opportunity costs of improved service delivery etc. The other is that there may be some circumstances (*force major*) in which further liberalization is not in the country's best interest. Should the government, once its posted bond, be forced to continue with liberalization or forfeit the bond? If these circumstances (*force major*) were easily verifiable they could be included in the terms of the bond contract as an "escape clause". It is likely, however, that many of these conditions are not verifiable by a court even when they are observable.⁵ Including them in the contract would, therefore, be of little use.

⁵ Note that we are making a distinction between observability (i.e., the parties involved in the contract can recognize whether an escape clause has been triggered), and verifiability (i.e., an independent court can ascertain this).

One way to resolve this issue is to create an independent body, say an international “commitment guarantee agency” (CGA), to ascertain whether the government is acting in good faith, i.e., whether the escape clause conditions have really been met. It would be possible to design such an organization with long-term incentives to be both neutral and fair. Since the only purpose of the organization would be to “sell” pre-commitment, it would have the incentive to build its reputation. In fact, the CGA could not only ensure the credibility of the liberalization but also the implementation of the *post*-reform assistance to the promised targeted sectors of society.

Much like the Federal Reserve is designed to maintain low rates of inflation but on occasion does slacken interest rates to prevent market meltdowns and deep recessions, such an agency too could be focused on making sure the government keeps its promises without punishing the government on occasions when keeping the promise is no party’s interest. The CGA should be international and therefore be able to insure commitment to liberalizations – or any other reform – in other countries. The agency would charge a fee for its service (which could also cover the administrative costs of placing the funds in a secure investment which would generate interest).⁶ The size of the fee would depend on the costs of verifying the escape clause as well as the conditions for releasing the bond (i.e., the government’s fulfillment of its commitment). An issue to be resolved for the case where the government provides cash is how to dispose of the proceeds in the case of default. This would have to be done in such a way as to ensure that the CGA is completely indifferent to the country’s fulfillment or default of its pledge.

Another institution to help the government signal serious intent and to provide signals for the government is to have a “betting market” on the likelihood of “default” by the CGA. This could be done by selling the assurance bonds on the open market. Such “market” signals would provide the government with timely information about how it is perceived and maintaining a high value of the probability as signaled by the market to help the government discover the effectiveness of various actions in signaling intent (the government could observe immediate changes in the lottery price after it announces certain actions).

⁶ Instead of actually coming up with the “cash”, the government could take out a loan from a multilateral development bank. In fact, the development bank itself could offer the service and not even have to put up the money.

We would first work out the theoretical properties of the optimal contract committing the government to reform, the structure of the CGA, and the betting market. Next we would consider the feasibility of creating such institutions for one the countries we are to work in.

Resource requirements: LOE: 40 days Research assistance: 2 months Travel: 1

3.3 Micro-level analysis

While the above analyses provide useful lessons for the design of reform strategies, they are by their very nature rather aggregative. In the Micro-Level, therefore, we delve down to the individual decision maker. At this level we pose the following multi-layered question. What would particular groups require as “proof” of government commitment for given types of complementary reform? A group might include urban SMEs, civil service employees, or medium-scale farmers. Complementary reforms refer to government promise for transition trade adjustment assistance and action to mitigate potential externalities. These might include a new or strengthened natural resources protection agency, new social benefits, a new SME credit facility, or a range of retraining programs.

We propose to develop and administer a contingent valuation survey to “test” the effectiveness of cooption of the various commitment options listed at the outset by the different likely stakeholders of trade liberalization. We will also determine the effect on cooption of alternative modes of USAID guarantees as well as government promises to introduce public participation into its commitments.

Resource requirements: LOE: 45 days Research assistance: 2 months Local team Travel: 2

4. Resistance from owners of asset-specific capital

Economics teaches us that unanticipated policy changes are inefficient, since investors cannot take their consequences into account. Thus, investment is made that may no longer be optimal and may even be loss-making, given the changes in relative prices that the policy change instigates. Here the policy change triggers an instantaneous capital loss. It is thus quite understandable that owners of such assets are a source of strong resistance to any policy change. Moreover, with a little thought it is clear that surprise policy changes can affect not just investors but also household investment and asset allocations, human capital formation (labor skill and idiosyncratic knowledge acquisition), and even public sector officials.

In our companion paper (Zinnes and Azfar 2002) we propose two classes of strategies for overcoming resistance from owners of asset-specific capital, gradualism and compensation. To determine which of these options is most appropriate and how to tailor the one selected for a given application, we propose Macro, Meso, and micro HPI studies, which we now describe.

4.1 Macro-Level analysis

[To be completed]

Resource requirements: LOE: days Research assistance: months Travel: 0

4.2 Meso-Level analysis

The idea is to affect the calculus of dissent. Dissenters perceive costs and benefits from a reform package. Benefits are of two types. The largest will be the direct and indirect economic gains from participating in the increased demand for domestic output as a result of trade liberalization. The other benefits will result from the complementary trade adjustment assistance policies and actions taken to mitigate the negative externalities and distributional effects of liberalization. On the cost side will be the aforementioned negative externalities and distributional effects.

The standard practice is to laud the first set of gains, namely the direct and indirect economic benefits of reform. While this may satisfy some of the prospective winners, we hypothesize that many other winners (not to mention losers) will not be convinced. In fact, we argue that after 25 years of hearing the word “reform” and observing its meager stream of benefits, most citizens of developing countries are either reform-fatigued or convinced that reforms are sponsored by elites who expect to benefit handsomely and that the chances of the average citizen to benefit also would only be coincidental. It may therefore be more effective to convince losers of the size of compensation. This is because it may be easier to show a particular mitigation policy will be implemented with certainty (i.e., that the benefits would be 100-percent certain) than it would be to prove that a stakeholder group is “likely” to receive direct or indirect economic gains from the trade liberalization itself.

We propose to run experiments to test the effectiveness of alternative dissemination methods to advertise the benefits trade liberalization. We will also examine the relative effectiveness of advertising insurance for (certainty) guarantees against losses versus convincing the voters about the (likely?) benefits of trade liberalization themselves.

Resource requirements: LOE: 30 days Research assistance: 2 months Travel: 2 trips

4.3 Micro-Level analysis

What sort of asset-specific capital leads to resistance? We also propose use the contingent valuation methodology (Zinnes and Bolaky 2002, section 5.3) to measure the size of resistance of key classes of asset-specific capital owners. This is useful since it provides an indicator of how great their resistance would be and how much actual compensation (however delivered) would be necessary to co-opt a dissenting group.

Resource requirements: LOE: 40 days Research assistance: 2 months Travel: 2 trips

5. Inappropriate LRJ environment

One of the many reasons that the gains from liberalization do not trickle down to the poor is that the poor do not have access to complementary factors, often because of poor institutions. The poor may for instance lack access to credit because commercial laws and law enforcement is poor and lenders do not believe that they would get their money back. Or the poor may not be able to take part in market activity because buyers do not trust them to provide good quality products and do not trust the effectiveness of legal remedies when they do not provide good quality products. The research proposals presented below address the question of how to improve the LRJ environment so that the poor can have better access to the gains from trade and how to improve the incentives of local governments so they would provide a better LRJ environment. The problem with improving LRJ is as often a problem of political will as of technical feasibility. The proposals below take this seriously and directly address the question of how to sharpen the incentives for local government officials to improve the quality of government.

To determine which of these options is most appropriate for a given application, we propose the following HPI studies.

5.1 Macro-Level analysis

The effect of law on growth. While cross-country analyses have shown that improvements in commercial law and the rule of law lead to economic growth, the lack of adequate data has prevented the clear demonstration of exactly which commercial laws are the optimal ones and which the most important to reform. The data has also not allowed the resolution of the question of

whether commercial law reform is more useful in countries where laws are reliably enforced –the data hints at this possibility which resonates with theory but there simply isn't enough to answer the question. One of the problems is that data on commercial laws is not coded for a large number of developing countries and another is that data on financial markets is sometimes missing. Also data on the relevant commercial laws at the early stages of development may not be available as the commercial law data sets consist mainly of commercial laws important for developed country commerce. These data could however be collected by a diligent graduate student which would help in the resolution of these questions. Following the collection of this data we would write a paper which could more clearly answer the questions of which commercial laws are the most important to reform and whether commercial law reform is more successful in countries where laws are actually enforced.

Resource requirements: LOE: 30 days Research assistance: 2 months Travel: 0

Does better rule-of-law lead to more successful trade liberalization? Another cross-country examination could be conducted on whether trade reform is more effective in countries which have already reformed their institutions. As with privatization (Zinnes, Eilat and Sachs 2001), it may in fact be the case that institutions need to be improved before the reform rather than after. As we have mentioned elsewhere in this document as well as other places the absence of reliable law enforcement etc. makes the transition from one activity to another more difficult. Since the gains from trade are predicated on such transitions, liberalization before institutional reform may be counter productive. Our econometric strategy would be to separately estimate the impact of openness on growth in well-governed and poorly governed countries (we could also estimate an equation using the entire sample including an interaction term of trade openness and institutional quality, the coefficient on this interaction terms would also indicate whether trade liberalization is more effective in well governed countries). We would use both the average growth rates and the growth rates of the poorest 50% of the population as the dependent variable.

Resource requirements: LOE: 30 days Research assistance: 2 months Travel: 0

Does support for liberalization depend on institutional quality? It may also be worthwhile to assess whether there is greater support for trade liberalization in well-governed countries. This might be true for several reasons. Citizens in well-governed countries may be less cynical about what motivates their governments to act in one way or another (so they may be less likely to subscribe to the public choice version of Murphy's law "trade reform will only be undertaken if the rich and well-connected want it, since I'm neither rich nor well-connected it is unlikely to do me any good"). Another reason may be that the transitions that private parties need to make for the gains from trade to be realized are easier in well governed countries. Capital markets work better giving SMEs and other transitional finance and government-sponsored training programs are more effective etc. Such an assessment of whether there is more support for trade reform in well governed countries would need a cross-country survey. This is potentially costly but perhaps worthwhile, especially as the US Government evaluates the prospects of extending NAFTA throughout the Americas. It is conceivable though that data on the relevant variables has been gathered by Gallup or some other international polling agency, in which case the marginal costs of the study will be much lower.

Resource requirements: LOE: 30 days RA: 2 months Cross-country survey Travel: 0

Ranking local governments on LRJ dimensions. An activity we could usefully undertake, which would sharpen incentives for local governments to improve governance and provide donors and others with data to evaluate programs, would be to develop a data base on assessments of local governments.

Data would be collected both using surveys of business men (perhaps also households) and also by conducting in depth studies of the local governments. (This is also the methodology used by the Economist Intelligence Unit for evaluating countries). An indicative list of the variables we would want data on is shown in Table 1.

Table 1: Indicative list of variables for the survey.

<i>Description</i>
Distance to international port in miles
Distance to international port in hours
The intrusiveness of internal trade restrictions
Time taken to get an electricity connection
Time taken to get a telecom connection
Number of electricity breakdowns per month
Number of telecom breakdowns per month
Amount of bribes a small enterprise (<5 workers) has to pay per month
Amount of bribes a medium enterprise (5-50 workers) has to pay per month
Amount of bribes a large enterprise has to pay each month

In addition to this information in depth studies of each locality would also be sponsored. These have several uses, they can be used as checks of the quality of data obtained by surveys and also allow the investigation of questions surveys can't easily measure. For instance there be some imminent change in government that would affect the expected profitability of investments; surveys would not catch that, but in-depth studies might. The combination of these two kinds of evidence could produce very useful information on the quality of local governments, the use of which by investors could sharpen incentives for local governments to improve the quality of governance.

Resource requirements: LOE: 90 days Research assistance: 4 months Travel: 1

5.2 Meso-Level analysis

Analytic narrative of Romania's deregulation program. One possible activity suggested by the discussion is an analytic narrative of IRIS's deregulation program in Romania which illustrates the idea of experimental federalism. As a part of a USAID program, IRIS offered Romanian cities the opportunity to take part in a deregulation program. This deregulation program consisted of five steps, some routine and others more challenging. Out of a total of 80 cities invited, 30 opted to join the program, and of these 4 completed all five steps. Those cities which scored "five stars" on the deregulation program were rewarded by a visit from the American Ambassador. Note that no monetary rewards were given, which may have contributed to program success by clarifying who "owned" the reform, and demonstrating to the cities that reform is its own reward. The visits by the American Ambassador were however helpful in giving visibility to the reforms which attracted the attention of other donors including the British and also private

investors. The success of the program, which was disseminated by workshops etc., attracted other cities who also increasingly adopted these reforms. Eventually even the central government became convinced of the benefits of these reforms.

This story demonstrates in detail how “experimental federalism” works. A few adventurous localities try reforms, these reforms appear successful – signaled by attracting private investment etc. – the success of these reforms is analyzed and disseminated, learning from their neighbors other localities also adopt these reforms, and eventually even the central government is inspired to reform itself. There are also some anecdotes suggesting that central governments are learning lessons from reforms undertaken by local governments in other countries.

An analytic narrative based on this experience would consist of a theoretical demonstration of the principles of experimental federalism, including an analysis of the necessary preconditions for reform to be successful and then match these theoretical assumptions and conclusions with facts obtained by interviews, and in depth study. We would also produce recommendations on how to improve the learning process which is central to the idea of experimental federalism. For example we would examine whether its cost effective to collect baseline, and post reform data, and analyze the results as a matter of routine, and whether and how USAID and recipient governments can encourage the widespread dissemination of the results using country wide tours by the officials of the most successful localities etc.

Resource requirements: LOE: 35 days Research assistance: 1 months Travel: 1

An impact analysis of reform programs. Another way to improve policy with analysis would be to conduct an impact analysis of local government reform programs.⁷ Programs could be designed to have some randomization in which municipalities the reforms are implemented – an example of a reform could be technical assistance to improve meritocracy in hiring. As discussed above in section 2 this is probably the most scientifically hardnosed way to evaluate programs, and the easiest to communicate to non-scientific audiences. Another use of evaluations and measuring outcomes USAID most cares about is that they allow the provision of incentives to USAID staff and contractors on the basis of outcomes important to USAID. However the drawback is that the design implementation and evaluation of an intervention cannot be comple-

⁷ An alternative to the prospective proposal in the text is to do a randomized retrospective analysis of Romania’s experience. This would compare the performance of municipalities who did and did not participate. This allows a better evaluation since a concrete counterfactual is included.

ted within the cycle of the Forums project. We would therefore need a follow-on project to complete this work.

Design and baseline evaluation:

Resource requirements: LOE: 100 days Research assistance: 2 months Travel: 2

Follow-up evaluation:

Resource requirements: LOE: 80 days Research assistance: 2 months Travel: 1

Campaign Finance Reform. Improprieties in campaign finance are a frequent and serious cause of misgovernance. This is as true in developing countries as in developed countries. The problem lies in the choice between privately financed campaigns, which lead to an unsavory *quid pro quo*, and publicly financed campaigns which would favor the incumbent.

The solution may lie in a system of electoral lotteries, financed by the government, which combine the ability of the market to gather information and the ability of the public sector to raise revenues. The government could put up a certain amount of prize money and offer lottery tickets for various candidates, which could be redeemed if the specified candidate won the election. As an illustrative example for the U.S., the U.S. government could auction off lotteries worth \$ 100,000,000 a month starting a year before the election. The sum total of costs would be \$1.2 Billion, which is small change for the U.S. treasury. The price of the lottery tickets would signal that people thought there was a non-trivial probability the person would win the election, or perhaps that people support the candidate and are buying the lottery tickets as a form of contributing to the campaign. To prevent prices being set by a few players in the market, the government could limit the number of lottery tickets any one individual could buy at \$1000. Thus the price would reflect the probability that the 100,000th buyer placed on the candidate (if buyers were ordered by the prices they were willing to pay).

With an appropriate cap the money raised by the sales of tickets for the candidate would go to the candidate. This would be the sole source of campaign finance. All other forms of campaign financing could be prohibited. The auctions would generate much interest in the press and financial markets and might actually help citizens focus on politics. The sums of money involved for other countries would be much smaller and the period over which the auctions are conducted would also typically be shorter in line with the shorter campaign periods in developing countries.

This proposal requires some clear thinking about the possibilities of multiple equilibria and how to avoid them –for example a perfectly good and *electable* candidate might not get funded because no-one believes she would win, and so she doesn't get the resources to run a campaign. Also its possible that at the early stages of a campaign several candidates should be encouraged that at later stages, so there are interesting design issues of the minimum probabilities (as reflected by the price off the lottery ticket) before a candidate is denied all funding or even the permission to take part in the election. Finally there are issues of local adaptability, in some countries the population may want many choices in others they may prefer relatively few. This information could be gathered using surveys etc. before the campaign finance regime is tailored to a countries specific circumstances. As with many other reforms, this could first be tried at the local level in some municipal elections, the process could then be assessed and fine tuned before applied to other municipalities or the national election.

Resource requirements: LOE: 90 days Research assistance: 1 months Travel: 1

Legal regulations for forming associations. There are at least two important ways in which private associations can contribute to the development and the goals of USAID. One of these is to provide oversight on government activities (often done by the media, human rights groups and political parties, but also by unions, trade associations etc.). The other is service delivery, often in health, education and micro-finance, especially important if government services are poor. These organizations have strong NIE foundations in having overcome the transaction costs associated with coordination and collective action.

These kinds of institutions need the appropriate legal framework to be created and to be successful in their assigned tasks. Governments can be guilty of both sins of omission (being too lax) and sins of commission (by being too stringent, or, as likely, too stringent about all the wrong things). For oversight associations, governments may even deliberately be too stringent or threaten to be overly stringent as a way of silencing them The Slovak government under Meciar, for instance, shut down a semi-private University which was critical of the government. President Putin in Russia has done the same.

Blithely making the legal and accounting requirements on NGOs and other civil society organizations lax is not an ideal solution either. Especially those organizations focused on service delivery may use this laxity to run “for profits in disguise” and divert, waste or misappropri-

ate donor funds. In Romania, for example, every politician had his own NGO. Perhaps a distinction needs to be made in the legal and accounting requirements from service providers and watchdog agencies – though again this is not trivial as some organizations like Universities straddle the two functions. The design of the appropriate environment for the flourishing of NGOs and civil society organizations is, therefore, an important issue to examine.

We propose to do a sort of transaction cost analysis of civil society. Our fieldwork proposal would consist of a serious study of the non-profit and civil society sector using surveys both of providers and of users and, perhaps, knowledgeable sectors of society like journalists. We would try to answer where and how NGOs get harassed by the government? Which types get harassed more (e.g., do the ones exerting oversight get harassed more than service providers)? Do they fear legal reprisals, and which laws would these feared reprisals invoke? The identification of these problems would help in the proposed reform to the laws regulating NGOs. The next stage of the research proposal would be the design of these regulations.

While its proper place would be in the Micro Level, below, we add here some additional questions, which would be pertinent in such a study. Do NGOs divert or misappropriate donor funds? How much nepotism in hiring do NGOs engage in? Do they require bribes for service provision? How committed are the members of the NGOs to their jobs?

Resources required: LOE 80 days RA: 2 months Local team Travel: 2 trips

5.3 Micro-Level analysis

Public sector survey on effectiveness of reforms. USAID can and does provide local governments with technical assistance to undertake several different kinds of reforms. Assistance can be given to improve meritocracy in hiring and promotions, by designing entrance exams or guidelines for advertising jobs and hiring. Alternatively USAID could focus on improving managerial accountability by providing TA on regular evaluations and budget monitoring. Or USAID could concentrate on improving political accountability by helping improve media coverage and analysis of local governments, or helping democratize political parties. However these decisions are taken on the basis of highly imperfect knowledge of which these of these reforms would be most effective. A serious survey based examination could improve USAID's knowledge of these questions. There are two ways to conduct such analyses; one involves a cross sectional examina-

tion of the source of good government, the other does an impact analysis of reforms (see next research proposal).

A survey of households and private enterprises can be used to assess the quality of service delivery by different government departments. Data from households can also be used to measure the extent of media penetration and media coverage of local politics. Public officials in these departments would also be surveyed to collect information on meritocracy and accountability in these organizations. The following regression could then be estimated:

$$\begin{aligned} \text{Quality of service delivery} = f(\text{managerial accountability} \\ \text{Political accountability – voting, media exposure etc.} \\ \text{Meritocracy} \\ \dots) \end{aligned}$$

This would assess which of these factors have the greatest impact on service delivery. The ideal place to conduct such an analysis would be the Philippines for several reasons. First USAID had a large program there, second we already have baseline data we collected in 1999 from 80 municipalities, third there are a large number of municipalities (1500) so in principle a large amount of data could be collected, fourth there are excellent local counterparts to work with at Social Weather Stations and other places.

Resource requirements: LOE: 40 days Research assistance: 2 months Travel: 1

Transition path, trade-restricting options. Developing countries – including such “success stories” as Korea, Taiwan, and China” along with others that have often done well, such as Mauritius, Indonesia, and China, have implemented trade-restricting policies and only over time have they liberalized. This raises two questions. First, why are there so many complex institutional “innovations,” which governments put into place rather than implementing trade liberalization? And second, since each country appears to have finally liberalized substantially, is there something to the idea of a trade liberalizing transition path?

The standard answers (Nugent 2002) typically reflect fears of unemployment, concerns of instabilities from the foreign sector, political economy issues, and an historical affinity to an import substitution orientation. Nevertheless, economists generally view these institutional mechanisms as misguided. Let us for the moment, however, ask whether from an NIE per-

spective there might be “good” reasons to implement such convoluted institutional arrangements. Given what we have learned from the successes and failures of privatization (Zinnes *et al.* 2002), might it be the case that countries find themselves trying to establish the proper institutions to avoid the negative outcomes embodied in their (justified) fears of trade liberalization while trying to benefit from the gains that trade liberalization has to offer?

For example, consider a country that unable to provide an adequate social safety net, environmental regulations, or strip away their redtape fast enough. Might, it make sense to create an EPZ in a geographically controlled area so as to avoid impacts that these institutional obstacles reflect? Similar arguments may exist for other trade-restricting institutional mechanisms.

While one may argue whether the following proposes are best categorized as “Meso”, we transition path perspective suggests three areas to pursue. First, we can carry out a HPI analysis of the most favored trade-restricting mechanisms in use. The idea is to understand better whether and how they solve the trade liberalization transition problem.

Second, if one finds through NIE that there are “good” reasons to consider transition path trade restrictions, then might we be able to apply the HPI approach to determine how improve their performance, both administratively as well as to capture further benefit from the foreign sector? Consider some examples. What does NIE have to say about improved designs for EPZs, once their NIE-economizing function is understood. One could study on the likely consequences of well-intentioned but over-optimistic duty drawback schemes and compare the transactions costs of duty drawbacks with EPZs. We propose therefore to conduct a study to examine how a country’s quality of law enforcement and structure of informal institutions make alternative schemes, such as the duty drawback or EPZs, preferable or work better. We also propose to compare the transactions costs of the schemes as well as examine whether the political dynamics of the country were such that the central government might allow a scheme to be decentralized to the municipalities.

Third, one consequence of weak LRJ environments is that some administrative schemes like duty drawbacks are not feasible or have more negative *unintended* consequences than positive intended ones. One possible response to this is improvements in the LRJ environment which have been discussed elsewhere in this section. Another response is to adopt administratively less demanding options like export processing zones (EPZs). In NIE terms, we might say that if the

transactions costs of administering duty drawbacks (including non-compliance) exceed the transactions costs of relocating labor, then EPZs should be used rather than duty drawbacks.

Finally – though perhaps too radical, one interesting institutional option inspired by the new wave of decentralization is to allow local governments to make their municipality into an EPZ. This has the politically tricky consequence of requiring a border between the EPZ municipality and the rest of the country, but a national government considering liberalization – and hence eager to learn about the likely consequence of liberalization – might allow some municipalities to try the EPZ option. If the experiment is successful, e.g., if the EPZ starts to attract factors from other municipalities (and hence expands its tax base), other municipalities might want to emulate it. Eventually the central government might be able to convince itself that liberalization was both economically beneficial and politically expedient. If so, one might consider, after a suitable pilot, a competition among municipalities to become, say, EPZs and choose from among these those which are most likely to succeed on HPI principles. This latter point is important because if one implements a reform nationally with negative consequences, this would stymie interest in future reform efforts. Municipalities would be selected on the basis of human capital, outward orientation, the quality of law enforcement and other factors. We could also collect baseline data to help the eventual impact analysis (which unfortunately for reasons of time and money would have to be done in a future USAID project).

Resource requirements: LOE: 50 days Research assistance: 2 months Travel: 2

6. Fears of negative externalities to the commons

One of the most vociferous concerns of both domestic and international opponents to trade liberalization relates, (at least) in the short run, to the likely negative externalities from the expansion of domestic production due to the increase in demand from foreign markets. These impacts are especially manifest in three areas, each having a disproportionate impact on the quality of life of the lower deciles of society. First, they create additional stresses to the urban environments, as migration to cities and industrial zones places greater demands on the already taxed transport, water and sanitation, and power grids. Second, to the (frequent) extent to which exports are intensive in the use of natural resources (including land via agriculture), an expansion of production may lead to an increased consumption of the country's natural resource base if the appropriate regulatory controls are not in place. Third, expansion of production generates more

water, air, and solid waste pollution, leading to a likely further degradation of environmental assets.

In our companion paper (Zinnes and Azfar 2002), we propose several options to address these concerns. They include ensuring clear property rights, information dissemination (public awareness), voice (public participation and stakeholder empowerment), sustainable financing (of regulation agencies and of public services; demand management with full-cost pricing), use of competition, agency skill upgrading, performance-based regulatory discretion, collective action, reduced transaction cost permitting, and product differentiation. To determine which of these options is most appropriate for a given application, we propose the following HPI studies.

6.1 Macro-Level analysis

We propose to conduct a series of cross-country assessments of factors influencing the effectiveness of externality mitigation strategies. One set will examine the impact of the timing of the improvement of regulatory agencies relative to when the implementation of trade liberalization occurs. A second set will examine the types of improvements that had the greatest ameliorative effect. Among the latter would include changes in the opportunity for civil society to exercise “voice” in regulatory processes.

It is also possible that it is not optimal to liberalize trade in all products. This might especially be true of trade in hazardous waste between democratic and dictatorial countries. Because a large part of the gains from trade in hazardous country are likely to accrue to the government of the dictatorial country – and, therefore, probably the dictator – and the costs spread over the hapless population it is possible that the trade would be undertaken even if the population of the country were not willing to accept the hazardous waste at the prescribed price. The waste may, therefore, be moved from a developed country, which has the infrastructure to dispose of it at lower environmental and human cost, to an underdeveloped country, where it would cost more harm. This is because the population of the developed country can make its government follow the citizens’ preferences but the population of the poor country cannot.

The research proposal would examine whether hazardous waste in fact flows from democracies to dictatorships and other “odious” governments and what the relative health costs of disposal are in the two countries. These could be measured in actual health costs or by willingness to accept “contingent valuation” methods. If indeed we found that the trade in hazar-

dous waste was driven by differences in the population's ability to prevent hazardous waste being dumped on them (their country's weaker governance) rather than differences in the willingness to accept hazardous in their backyard then we may go some way to explaining why Larry Summer's infamous memo – which outraged almost all non-economists but was defended by many economists – was in fact misguided.

6.2 Meso-Level analysis

We view several useful study opportunities that could help address the mitigation of externalities. These focus on greater use of competition, internalization of risks, empowerment of collective action, and pre-reform assessments of institutional weaknesses. The analytic narrative would be one of the tools employed here. Let us briefly describe these in turn.

Greater use of competition. Mitigation of trade-related externalities will require more effective regulatory authorities. Regulatory effectiveness is about both service cost-effectiveness as well as service quality. Viz. the latter, we propose to illustrate how to assess the options for introducing competition into regulatory provision. Examples here include outsourcing of laboratories and monitoring (for environmental and water agencies) and use of “yardstick” concessions for water management and raw water provision (or solid waste collection). Just like accounting firms, regulatory agencies themselves require government oversight but this can be randomized rather than comprehensive. Allowing firms to compete for regulatory oversight while insisting they adhere to broad regulatory guidelines could improve efficiency. It may make sense to insist that firms change their regulator once in a while, as is being proposed in the *post-Enron-Anderson* accounting world.

Internalization of risks. We propose to illustrate how to design and field-test schemes for internalizing occupational health risks so that firms pay risk-adjusted contributions to worker health benefits. Similarly, we propose to illustrate how to design and field-test a scheme to use tradable development rights to enforce zoning and to control urbanization externalities from output growth.

Collective action empowerment. We propose to illustrate how to identify and set up organizations to directly monitor and control externalities. Examples here include river basin commissions, public participation mechanisms in the permitting process, and community-based management regimes (for multiple-use of sensitive or common-pool areas).

Pre-reform institutional assessments. We propose to illustrate how to identify and analyze potential regulatory stress points from the onset of trade liberalization. Also included here would be how to assess the appropriateness and scope of land cadastre and property collateral registers.

6.3 Micro-Level analysis

We stress in our companion paper (Zinnes and Azfar 2002) the importance of increasing the autonomy, independence, and governance of regulatory agencies. While higher employee compensation is central, we also underscore the need for performance-based regulatory discretion. We therefore propose to illustrate how to identify and design such schemes. Secondly, we show how to use analytic narratives to disentangle principal-agent and conflict-of-interest problems in regulatory settings, since these drastically reduce the effectiveness of the agencies involved. Of particular concern is when there is insufficient separation between the public agency that is responsible for sales (e.g., of raw water, stumpage, or even urban development rights) and the associated regulatory authority (e.g., the department of water, national forest service, or ministry of planning).

We believe that of central importance to the effectiveness of regulatory bodies (as well as public services) is its sustainable financing. We therefore propose to provide an institutional methodology to analyze for a given set of country initial conditions the pros and cons of using user fees for regulatory services as a source of earmarked funds for its operations. Other options here for illustrative analysis would include how to assess the degree of deviation from full-cost pricing that exists for public services as well as for regulatory agencies.

7. Transitional rigidities impeding the private sector's response

Change creates uncertainty and uncertainty leads to transaction costs. Many poor and middle class people lack the knowledge and resources to easily make the necessary transitions to benefit from trade openness. People might not know about potentially profitable activities, they may lack the technical expertise to actually undertake them, or the financial resources needed for these new activities. The lack of finance is itself related to informational imperfections which dissuade lenders from lending to strangers. Finally, even if agents have some resources, they may

be unwilling “to bet it all” on a new venture in changing times, even on activities which are profitable in expected value.

To help the process of transitions USAID can help to train people in the private and public sectors, and provide them with finance and insurance during the transitory period. We consider four proposals in this section

- On the evaluation of training programs, and the use of evaluations to provide incentives for trainers and USAID staff
- On the application of group lending to SMEs
- On the potential for small scale equity markets
- On whether the provision of insurance might make SMEs more willing to take risks
- On identifying public sector rigidities to firm entry

7.1 Macro-Level study

[To be completed]

7.2 Meso-Level study

Several applications of analytic narratives may be considered.

Evaluation of Programs. We could conduct a theoretical examination of the appropriateness of group-lending when the most profitable projects – in expected value – are somewhat risky. There is some reason to expect that in the presence of group lending and peer pressure managers would be prevented from investing in risky projects of positive net present value. We would examine both the theoretical predictions on this point and the relevance of this concern to countries where we are working through interviews etc. This would be combined with information based on in-depth interviews and mini surveys on whether in fact profitable opportunities were risky, and whether group lending and peer pressure prevented people from undertaking risky, profitable investments.

Resource requirements: LOE: 30 days Local expert Travel: 1 trip

Analytic narrative on scope for equity markets. Markets for small scale financial instruments tend to be markets in debt rather than equity –even in Muslim countries where debt finance is discouraged. Part of the problem is poor accounting standards which makes the mea-

surement of profits difficult. A thorough examination based on theory and interviews may lead us to better understand why equity markets haven't emerged and whether institutions similar to equity finance are in fact potentially profitable.

Resource requirements: LOE: 30 days Local expert Travel: 1 trip

Analytic narrative on insurance markets. Fear of destitution may prevent the owners of SMEs from entering the brave new world of new markets. The provision of some insurance may give them the heart to take a few risks, but over-insuring them would blunt their incentives for success. We need a clever design of the insurance scheme to overcome these dual problems.

The research project would involve first a theoretical and case study examination of whether these concerns are in fact important. If we find that these concerns are important, the next step would be the design of an insurance scheme that preserves incentives for hard work and success but also gives SME managers the cushion to be willing to take a few chances.

Resource requirements: Prep: LOE: 60 days Local team Travel: 1 trip

7.3 Micro-Level study

One basic activity that can help people adjust to changing times is training. Small manufacturers and small farmers may both need to be retrained for new activities. Managers and farmers both need to learn about new production techniques and new markets. Farmers may also need to learn new crop rotation patterns etc. to prevent sharp declines in the quality of the farm-land. USAID can help sponsor the development of training programs, for businessmen, farmers and public officials to help them deal with the new regime. USAID could also sponsor project evaluations, using user surveys, direct assessments of learning and assessments of changes in real world's activities as a result of the training program. These evaluations themselves have two purposes. First they help USAID assess project effectiveness. Second, they provide USAID with information on the basis of which AID can provide incentives for service providers, and indeed its own staff.

Four levels of evaluations can be conducted: satisfaction, technical, economic and political-economy.

- 1: User surveys on the quality of training provided
- 2: Exam-based assessments of learning
- 3: Survey-based assessments of changes in economic activity due to training

4: Survey-based assessments of changes in support for reform due to training

These are ranked in increasing order of both usefulness and difficulty of measurement (i.e., the most useful are also the hardest to measure).

One of the central principles of NIE as discussed in Azfar (2002) is that it is best to base incentives on a broad set of variables, and these variables should include measures that the principal is ultimately interested (in this case we expect USAID is ultimately interested in economic improvements and increased political support for reform, and only incidentally in the quality of the training itself). Failure to do this can lead to agents focusing on maximizing values of the variables incentives are based on (test-scores), possibly even to the detriment of variables of ultimate interest. In fact, this particular concern may be more relevant to “Potomac than Pakistan” as even “teaching for the test” is probably better than not showing up at all, or teaching really badly. Poorly designed incentives may encourage mediocrity, but in many places, mediocrity may not be so bad. This like many other conjectures is in principle testable with the right data which we propose to do below.

We could undertake to conduct evaluations based on all these different measures, using both tests and surveys. Such an evaluation can even be conducted randomly – with different localities being chosen randomly for different teaching methods and different incentives. For instance we might pick four sets of venues

- 1: a placebo group which got no training program,
- 2: a set of venues with training programs without explicit incentives,
- 3: a set of venues where the trainers got incentives based on test scores, and
- 4: a set of venues where trainers got incentives based on test scores and improvements in economic outcomes.

Then a comparison of economic outcomes across the four groups would allow us to assess whether the program is effective at all and if so what incentives should be based on. A comparison between group 2 and 3 would help us assess whether the concern about imperfect incentives apply to training programs in the country we have chosen.

Finally the results from this work can help us design programs that are applied more generally.

Resource requirements:

Design of training programs and assessment:	LOE: 120 days	RA	Travel: 1 trip
Redesign of training program:	LOE: 40 days		Travel: 1 trip

Public sector rigidities to firm entry. The new wave of trade liberalization requires adherence to regulatory standards –environmental, labor etc.- both because they are required by the WTO and some regional trading blocks, and because consumers –especially in Europe- appear to care about them. Public officials might either be unable or unwilling to actually ensure compliance. Inability is perhaps best dealt with by training and other forms of capacity building discussed in earlier sub-sections.

However, as often as not, the real bottleneck is unwillingness to ensure compliance. This may be either because public officials are short-sighted and believe that giving local producers a break might help local industry or because they are bribed to look the other way. There are a number of institutional solutions to these problems. For instance it may be optimal to have two regulators who can provide oversight over each other. However such an institution which may improve performance in well-governed countries may actually lead to more abuse than a single regulator in corrupt countries. Another might be to encourage environmental NGOs or unions to exert oversight. Again such an institution will only work as well as the motivations that govern members of the NGO or union.

Thus, it is *ex ante* difficult to say what institutional reform is most effective and what potentially counter productive and a thorough examination of the countries social structure and informal institutions is needed before we can discover the optimal design of formal institutions. To examine these issues we would first examine the theoretical predictions on the effectiveness of different institutions in different informal settings and then conduct a series of interviews etc. to discover the nature of the relevant informal institutions in the country before proposing a new institutional design.

<i>Resource requirements:</i>	Prep: LOE: 40 days	Local team	Travel: 1 trip
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8. Non-obstacle-specific studies

There are several studies which may be useful that do not fit into one or another specific obstacle. We describe some examples here.

8.1 Macro-Level analysis

Section 2.1 of the HPI approach (Zinnes and Bolaky 2002) proposes a method to extract rules of thumb or lessons learned concerning characteristics that make a USAID intervention successful. These characteristics might include those about USAID, itself, the nature of the implementer and its USAID contract⁸, the recipient government, final beneficiary, other donors, and, of course, the intervention or activity itself.

The following linear empirical model at a macro level could be estimated:

$$S_a = \mathbf{a}_0 + \mathbf{a}_1 ACT_a + \mathbf{a}_2 UDC_a + \mathbf{a}_3 MIS_a + \mathbf{a}_4 RGA_a + \mathbf{a}_5 IMP_a + \mathbf{a}_6 CON_a \\ + \mathbf{a}_7 BEN_a + \mathbf{a}_8 USG_a + \mathbf{a}_9 DON_a + \mathbf{a}_{10} EXO_a + \sum_j \mathbf{a}_j CROS_{a,j} + \mathbf{n}_a$$

where S_a , the degree of success of a given activity in a given programmatic area, is to be explained in terms of the following right-hand side variables:

- ACT_a , which is a vector of activity types
- UDC_a , a vector of characteristics describing the involvement of USAID/WDC;
- MIS_a , a vector of characteristics describing the involvement of the Field Mission;
- RGA_a , a vector of characteristics describing the recipient counterpart agency and its contributions to the activity;
- IMP_a , a vector of characteristics describing the implementer(s) and their contributions;
- CON_a , a vector capturing the type of contractual arrangement between USAID and the implementer(s);
- BEN_a , a vector of characteristics describing the beneficiary and their needs;
- USG_a , a vector capturing the bearing of the U.S. Government to the activity;
- DON_a , a vector describing characteristics of other donors involved in the same line of activity in the country;

⁸ Here we use the word, “contract” in the NIE sense, not in the procurement sense.

- EXO_a is a vector capturing recipient country (exogenous) initial conditions and n_a represents all the other factors that affect S_a but are not explicitly modeled. CROS allows for interaction or cross effects between any 2 explanatory variables.

The fixed or random effects techniques can be used to control for other slow changing country characteristics such as institutional environment not captured by EXO_a or else for any important relevant factors whose presence is not captured by any of the specified right-hand side variables.

One research idea is to estimate the above model by looking at all past USAID-financed activities in the programmatic area of small and medium size enterprises development which will give us a panel dataset relating to different types of activities in different countries (cross-sections) corresponding to different time periods. Depending on data availability, the same exercise can be repeated for various broad categories of SME activities (e.g. technical assistance, technological upgrading, financing initiatives such as micro-credit, increased market access abroad, and trade liberalization initiatives) to ascertain the differential effects of the various explanatory factors on S_a per category of activities. Dummy variables, on the right hand side, can be also be used for trade liberalization activities (as one category of activities) to situate the impact of the obstacles as identified in Zinnes and Azfar (2002) on the success of trade liberalization.

Resource requirements: LOE: 15 days Research assistance: 3 months Travel: 0

8.2 Meso-Level analysis

[To be completed]

8.3 Micro-Level analysis

As described in section 5 of the HPI approach (Zinnes and Bolaky 2002) evaluation is an important part of activity design. Moreover, it mentions several points in the activity process where evaluation can be beneficial. Let us consider an example of an Activity Early Warning System.

In many parts of this paper we have described how projects can and should be evaluated on far richer data than is currently the case. In addition to the self assessments of service providers and process evaluations by CDIE, projects could be assessed on the basis of information from service users on satisfaction ratings, economic improvements and increased political support for liberalization. This information could then be used to provide incentives for USAID

staff and contractors involved in projects. It seems likely this in itself would lead to a considerable improvement in the quality of USAID projects.

In addition to using the eventual assessment for motivating staff and contractors USAID could also use self selection in USAID's internal labor market and the market for contracts to collect information on expected project success and receive early warning signals before a project is implemented. The mechanism for doing this is as follows. The project would be designed as it currently is by the mission with some Washington input. The project design would then be circulated to CDIE which would develop indicators for the five levels of success (the information for these measures would be collected in surveys as described above).

1. Unacceptable
2. Below expectations
3. As expected
4. Above expectations
5. Excellent

Staff and contractors would be rewarded for 4 and 5 (perhaps even for 3?) and punished for scoring a 1 or 2.

The project would be circulated to staff looking for a new rotation and to contractors (identified by the SEGIR categories as being appropriate). A widespread unwillingness to accept the project on the basis of the expected performance as defined by CDIE would then provide a warning signal to CDIE, senior USAID staff and more generally the US government that something was amiss. Staff and contractors could also be asked which of a number of factors were responsible for their unwillingness to participate (were they not a good match for the project - they could be restricted to only use this reason/excuse to [say] 2 of the 10 projects proposed to them, was there something amiss with the mission director, the country's government, the project design,). Staff and contractors could be dissuaded from frivolously rejecting projects by two mechanisms. First, they could be made aware that a reluctance to take on a project would make it likely they would be interviewed about it and would have to display knowledge of the project. Second, the eventual grading could be done on a curve so a staff member or contractor who accepted a project that most rejected and scored a 3 would be rewarded, even at the expense of those who scored a 4 on projects that everyone wanted.

9. Country selection criteria

We employ three criteria for the selection of which analyses and countries to use. First, since our goal is to motivate the importance of the NIE perspective, we choose applications for which institutional obstacles are paramount. Second, since we want to illustrate the use of the HPI approach, we choose analyses which are central to the approach. Thirdly, since the Forums Project has a limited financial budget and (calendar) time frame, we focus on analyses which are feasible to implement under these constraints.

Based on these general criteria, we propose to select three of the following four countries/regions, CARICOM in Central America, Ghana in West Africa Romania in Eastern Europe, and The Philippines in East Asia. There are additional factors, which we now describe, that motivate us to consider these countries/regions.

The CARICOM group (Guatemala, Costa Rica, Nicaragua, Honduras, and El Salvador) all share a fairly common culture and history, though the share of indigenous Indians differ. Many of their other initial conditions are also similar. This makes statistical inference much easier since variation in outcomes is less likely to be cultural or geographic. These countries all belong to their namesake regional trading block, so intra-regional trade links and initiatives already exist and would provide a rich set of retrospective data and stylized facts. They also all are candidates for membership in the (future) Free Trade Area of the Americas. This is a particularly salient factor, since President Bush has placed trade capacity building and WTO accession preparation high on the USG (regional) foreign policy agenda. Moreover, the LAC Bureau of USAID is in the midst of designing additional regional assistance linked to trade facilitation. Together these latter factors suggest that the USAID missions in the region would be both receptive to the results of our analysis as well as agreeable to cooperate with our field work.

While the CARICOM group may be thought of as a region with several similar small countries, the Philippines may be considered a country with several “similar” small regions. The country is divided into 1500 municipalities, which have directly elected governments responsible for much of service provision, making statistical comparisons across municipalities meaningful. The Philippines also has a history of Spanish involvement. The Philippines, like CARICOM, has had a rich (more recent) history of trade and cultural influences with the United States. This con-

trast will allow us to analyze the importance in sovereignty in interpreting our results. On the other hand, the Philippines is a populous country and has also had recent experience with export processing zones, which still offers some additional idiosyncratic features to study.

There are several special factors that we believe make Romania an appropriate demonstrating NIE principles in trade reform.. First, IRIS has several longstanding USAID, SME activities in the country. These activities have been lauded for their institutional innovativeness and therefore potentially hold many lessons. Second, the country is currently acceding to the European Union and therefore allows us to observe trade reform in progress within the context of trade block accession. An assessment of how the carrot of EU accession motivates a country to reform may also hold lessons for the expansion of the WTO or FTAA. Finally, the Forums Project director has a half-decade of experience in the country and has drafted several important laws with potential relevance to SMEs and trade.

Ghana has a long history of openness, as well as a spot of stability in an otherwise turbulent region. It has a long track record of donor projects related to SME empowerment. Its record, however, has been quite mixed. As such, we believe the country offers an important source of lessons to learn. Perhaps more important, though, is that Ghana is in Africa, a continent USAID is likely to remain in for many years to come.

10. Summary of proposals and their costs

We have started out with six institutional obstacles to SMEs gaining access to the benefits of trade liberalization, as identified by Nugent (2002). Zinnes and Azfar (2002) analyze these obstacles and design a number of institutional reforms or “options” to overcome them. Which options are appropriate vary with a country’s initial conditions. Therefore, in the previous sections of this paper, we have proposed several studies based on the HPI framework to illustrate how to choose among options. Table 2 summarizes the obstacles, their options and their costs.

We can also illustrate where these empirical study options might be applied in the USAID programmatic cycle. This is shown in .

We expected the financial and human resources required to implement the proposals suggested herein to exceed those available under the Forums Project. This has been done intentionally for several reasons. First, it provides the HPI end-user with a richer set of examples with which to understand the approach. Second, it allows USAID (and the Forum-3 discussants) to

select a subset of activities based on need and merit, rather than being offered a fixed list. Finally, the broader choice of fieldwork alternatives means that if at the early stages of work one becomes infeasible, we still have fall-back options readily available.

Two final comments should be made. First, in developing these preparatory study activities, we have found that the need to complete the investigation within the calendar time of the project to limit some otherwise useful proposals. In particular, prospective pilot field experiments, which might pilot a series of alternatives, could not be considered. Second, at this juncture we have not related the study activities to specific processes within the USAID programmatic cycle of activity identification, implementation and evaluation. This important matching process (or deconstruction of a study to allow for matching) will be done once the actual selection of the studies to be undertaken has been made.

Table 2: Summary of obstacles, their options and costs

Study component (option)	Calendar Time	Costs		
		LOE (research assistance)	Local support	Travel
I. Market structure impediments				
II. Government inability to pre-commit				
III. Resistance by owners with highly asset-specific investments				
IV. Inappropriate LRJ environment				
V. Negative externalities to the commons				
VI. Transitional rigidities impeding the private sector's responses				

Table 3: Selected study options across USAID programmatic cycle by HPI analysis level: The Market structure obstacle.

<i>Abbr.</i>	<i>USAID programmatic cycle*</i>	<i>Study option by HPI level of analysis</i>		
		<i>Macro Level</i>	<i>Meso Level</i>	<i>Micro Level</i>
CSP	Country strategy plan			
AD	Activity design			
AI	Activity implementation			
AE	Activity evaluation			

*CSP-includes pre-study and parameter setting exercise; AD-includes the identification and design of the activity to be carried out; AI-refers to the type of implementer characteristics, choice of procurement vehicle, size of budget and timeframe, and whether it is done from Washington or the field.

Table 4: Selected study options across USAID programmatic cycle by HPI analysis level: The LRJ Obstacle.

<i>Abbr.</i>	<i>USAID programmatic cycle*</i>	<i>Study option by HPI level of analysis</i>		
		<i>Macro Level</i>	<i>Meso Level</i>	<i>Micro Level</i>
CSP	Country strategy plan	Institution quality threshold for net gains to trade liberalization	Regulatory environment for association formation	
AD	Activity design		Experimental federalism	NIE analysis of EPZ
AI	Activity implementation			
AE	Activity evaluation		Impact analysis of municipality performance; Benchmark indicators	

*See Table 3.

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